

1992

Thorup Brothers Construction, Inc. v. Auditing Division of the Utah State Tax Commission : Brief of Appellant

Utah Supreme Court

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IN THE SUPREME COURT

STATE OF UTAH

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:
THORUP BROTHERS CONSTRUCTION, :
INC., :
:
Petitioner and :
Appellant, : Case No. 92-0184
:
-vs- :
:
AUDITING DIVISION OF THE :
UTAH STATE TAX COMMISSION, :
:
Respondent and :
Appellee. :
:
--oo0oo--

BRIEF OF APPELLANT

APPEAL FROM THE ORDER OF THE UTAH STATE TAX COMMISSION
DATED MARCH 10, 1992

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UTAH

STATE OF UTAH

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JURISDICTION

The Utah Supreme Court has jurisdiction in this matter pursuant to Utah Code Annotated, §§ 63-46b-16 and 78-2-2(e)(ii), and Rule 14 of the Utah Rules of Appellate Procedure.

ISSUES PRESENTED FOR REVIEW

1. Are materials purchased directly by a tax exempt religious, charitable and educational institution exempt from sales and use taxation, when incorporated into a construction project upon real property owned by such exempt institution?

2. Is the regulation enacted by the Utah State Tax Commission, R-865-19-58S, inconsistent with Utah Code Annotated, §§ 59-12-104(8) and (12) and with Article XIII, Section 2 of the Utah Constitution?

3. Is the Tax Commission's interpretation and application of said regulation violative of applicable Utah statutes and applicable provisions of the Utah Constitution.

STANDARD OF REVIEW

A. Sections 63-46b-16(4)(d) and (g) govern the standard of review for the issues raised in this appeal. The decision of the Commission may be overturned if the petitioner has been substantially prejudiced by the Commission having erroneously interpreted or applied the law. Chris & Dicks Lumber and Hardware v. Tax

Comm'n., 791 P.2d 511 (Utah 1990); Savage Industries, Inc. v. Utah State Tax Comm'n., 811 P.2d 644 (Utah 1991).

B. In Hurley v. Board of Review of the Industrial Comm. of Utah, 767 P.2d 524 (Utah 1988), this court noted that no deference should be given to an agency construing statutory terms or applying statutory terms to the specific facts of a case, unless the language or the application of the law to the facts is subject to the agency's expertise. 767 P.2d at 527, citing Bennett v. Industrial Comm'n., 726 P.2d 427, 429 (Utah 1986). In this case, no deference should be given to the Tax Commission's construction of the statutes.

RELEVANT STATUTES

Utah Constitution, Article XIII, Section 2:

(1) All tangible property in the state, not exempt under the laws of the United States, or under this Constitution, shall be taxed at a uniform and equal rate in proportion to its value, to be ascertained as provided by law.

(2) The following are property tax exemptions:

* * *

(c) Property owned by a nonprofit entity which is used exclusively for religious, charitable or educational purposes

U.C.A., § 59-12-104:

The following sales and uses are exempt from the taxes imposed by this chapter:

* * *

(8) sales made to or by religious or charitable institutions in the conduct of their regular religious or charitable functions and activities;

* * *

(12) sales or use of property which the state is prohibited from taxing under the Constitution or laws of the United States or under the laws of this state

Rule R-865-19-58S, Utah Rules of Administrative Procedure:

A. Sale of tangible personal property to real property contractors and repairmen of real property is generally subject to tax.

1. The person who converts the personal property into real property is the consumer of the personal property since he is the last one to own it as personal property.

2. The contractor or repairman is the consumer of tangible personal property used to improve, alter or repair real property; regardless of the type of contract entered into -- whether it is a lump sum, time and material, or a cost-plus contract.

3. The sale of real property is not subject to the tax nor is the labor performed on real property. For example, the sale of a completed home or building is not subject to the tax, but sales of materials and supplies to contractors and subcontractors are taxable as sales to

final consumers. This is true whether the contract is performed for an individual, a religious institution, or a governmental instrumentality.

4. Sales of materials to religious or charitable institutions and government agencies are exempt only if sold as tangible personal property and the seller does not install the material as an improvement to realty or use it to repair real property.

STATEMENT OF THE CASE

A. Nature of the Case.

This appeal seeks review of the Findings of Fact, Conclusions of Law and Final Decision of the Utah State Tax Commission (the "Commission"), dated March 10, 1992, which determined a sales tax deficiency was owed by petitioner in connection with personal property purchased by Judge Memorial Catholic High School and used in conjunction with the construction of certain improvements by the petitioner at Judge Memorial Catholic High School in Salt Lake City, Utah.

B. Course of Proceedings Below.

As a result of a field audit conducted by the Auditing Division of the Commission, petitioner received a statutory notice, dated October 13, 1989, assessing additional sales tax in the amount of \$26,328.30, plus interest. R. 244. Petitioner timely filed a Petition for Redetermination (R. 240-41) and a formal

hearing was held before the Commission on June 4, 1991. Virtually all of the facts were stipulated and only limited testimony was presented at the hearing. R. 206-210.

On March 10, 1992, the Commission entered its Findings of Fact, Conclusions of Law and Final Decision. R. 7-26. Petitioner timely filed a Petition for Review of the Commission's Final Decision on April 9, 1992. R. 4-6.

C. Statement of Relevant Facts.

1. The tax in question is sales and use tax and the period in question is July 1, 1986, to June 30, 1989. R. 7.

2. The Catholic Diocese of Salt Lake City is organized as the Roman Catholic Bishop of Salt Lake City, a corporation sole (the "Diocese"). The Diocese owns and operates Judge Memorial Catholic High School ("Judge Memorial"). Judge Memorial is not separately incorporated, but does have a Board of Financial Trustees which oversees the funding and non-academic operation of the school. R. 8.

3. On July 8, 1987, the Diocese entered into a contract with petitioner for the construction of an addition to Judge Memorial, which included an auditorium, music room and locker rooms. R. 8.

4. An engineer who was a member of the Board of Financial trustees, James Maher, volunteered to oversee the project, at times making his own engineering calculations and offering engineering

suggestions regarding construction. R. 8.

5. As part of the contractual arrangement, Judge Memorial reserved the right to donate materials to be used in the construction of the facility. R. 8.

6. Addendum No. One to the contract provides, in pertinent part:

General - Cost savings: The Contractor shall assist and coordinate as necessary with the Owner [Judge Memorial] as a tax-exempt organization, may wish to purchase major items of equipment or materials to gain credit for sales tax. The Contractor [petitioner] shall consider the use of any donated equipment or services if they meet the requirements of the contract documents.

R. 48.

7. Judge Memorial exercised its contract option on the project to furnish materials. R. 8.

8. Judge Memorial secured lists and specifications from the contractor and Judge Memorial then issued its own purchase orders to the vendors for the materials. R. 8-9.

9. Purchase orders totaling \$374,102 were issued by Judge Memorial. R. 8.

10. With regard to materials purchased, the vendor delivered the materials to the construction site, where they were received, inspected, and stored by petitioner or a subcontractor and by Judge Memorial prior to use. The vendor then sent invoices to either the

petitioner or subcontractor for approval. Upon approval, the invoices were sent to Judge Memorial and a check was issued directly by Judge Memorial to the supplier. R. 9.

11. Judge Memorial issued checks totaling \$422,226 for materials purchased in this manner. The petitioner credited Judge Memorial with payment of \$447,580, representing the amount actually paid for materials, plus sales tax, which petitioner had included in its bid for the contract. R. 9.

12. Change orders were not issued reflecting these credits for material purchased. R. 9.

13. Warranties on the purchased materials ran to Judge Memorial. Judge Memorial is responsible for enforcing these warranties. R. 9.

14. Judge Memorial hired E.W. Allen and James S. Bailey, independent structural engineers, to work directly for Judge Memorial to perform structural engineering for the project. Scott, Louie & Browning, Architects, retained the services of The Rhoads Company, Inc., Joe Rhoads and Paul Horton, masonry inspectors, to conduct an ongoing inspection of the masonry work on the project. R. 9.

15. Prime contracts existed between Judge Memorial and Scott, Louie & Browning Architects, and petitioner. Subcontracts were entered into by both prime contractors. R. 10.

16. Judge Memorial obtained insurance to protect against the risk of loss of the materials through Pacific Employers Insurance Company, which named as insured, Judge Memorial and which contained an endorsement which provided:

We will also cover materials, equipment, supplies and temporary structures on your "premises" or in the open (including property inside vehicles) within 100 feet (30.5 meters of your "premises" used for making additions, alterations or repairs to your "real property" at "covered locations".

R. 10.

17. Surplus materials were retained by Judge Memorial, and have been stored at Judge Memorial for use in repairs and replacements on the building. R. 10

18. Petitioner purchased and paid sales tax on materials used in the construction of the Judge Memorial addition with the exception of those materials purchased directly by Judge Memorial.

R. 10.

SUMMARY OF ARGUMENT

On appeal, petitioner asserts that the Commission erred in determining that petitioner is liable for the sales tax on personal property purchased directly by Judge Memorial. Petitioner asserts that Article XIII, Section 2 of the Constitution of the State of Utah intends to confer tax-exempt status on Judge Memorial, a religious and educational entity, which should not be abrogated by

agency rules which impute ownership to petitioner as the "consumer of the personal property". R. 11.

ARGUMENT

POINT I

THE AUTHORITY UPON WHICH THE COMMISSION RELIED IN ITS FINAL DECISION IS INAPPOSITE AND IS NOT CONTROLLING IN THE CASE AT BAR

In its Final Decision, the Commission relies on several decisions of this court in support of Rule R865-19-58S and its conclusion that the person who converts personal property into real property is the consumer of the personal property since he or she is the last person to own it as personal property. The Commission's reliance on these decisions in this case, however, is misplaced.

In Utah Concrete Products Corp. v. State Tax Com'n, 101 Utah 513, 125 P.2d 408 (1942), a manufacturer sought to avoid sales and use tax on material sold to contractors in circumstances where the material was to be used in the construction of public roads. The language contained in that decision demonstrates petitioner's point here. Discussing the chain of ownership of the property, the court noted that the manufacturer looked solely to the contractors for their payment and not to the state, which, as a public entity, was exempt from sales tax. Id. at 411. In this case, the vendors which sold the goods and materials in dispute, sold directly to

Judge Memorial. While it is true that the invoices were sent to petitioner and other subcontractors for approval, Judge Memorial was liable for the payment of those invoices and the vendors looked solely to Judge Memorial for payment.

The Commission also relies on Ford J. Twaits Co. v. Utah State Tax Commission, 106 Utah 343, 148 P.2d 343 (1944). In that case, the court noted that the parties had entered into a contract with full knowledge of local sales and use taxes and the government entity reserved the right to issue exemption certificates to avoid these taxes. Id. at 344. That the government chose not to do so was the best indication that the government did not intend to exempt the contractor from the sales and use taxes. Otherwise, the court noted, it would have been a simple matter for the government to have authorized the contractor to purchase materials as an agent for the government, an exempt entity. Id. at 345. In the instant case, the parties also had full knowledge of the existence of local sales taxes and entered into an arrangement whereby Judge Memorial, the tax exempt entity, would purchase materials directly, free of tax, as it is entitled to do pursuant to the provisions of the state constitution and applicable Utah law.

The Commission also relies on Olson Construction Company v. State Tax Commission, 12 U.2d 42, 361 P.2d 1112 (1961). That case, an action for refund of sales tax, involved a subcontractor who

provided materials to a federal construction project. As in the present case, the subcontractor did not claim that it was a tax exempt entity, but claimed that materials it had sold to the prime contractor with the United States Government should be free of tax. The Olson Construction case does not present a situation where the tax-exempt entity directly purchased materials and the materials were incorporated into real property improvements.

Finally, the Commission cites Tummurru Trades v. Utah State Tax Com'n., 802 P.2d 715 (Utah 1990). As with all the other cases cited by the Commission, this case is used to support the proposition that petitioner, having purchased personal property which was intended to be used in constructing improvements to real property, is the "ultimate consumer" of the property and, thus, is subject to sales tax on the property. However, the decision of the court turned on the failure of the taxpayer to keep and provide the Commission with records of exemption certificates or other evidence that sales were made to out-of-state customers. Therefore, the taxpayer could not meet its burden of establishing that it was entitled to an exemption. In this case, it is undisputed that petitioner provided Judge Memorial with listings of specifications for materials and that Judge Memorial purchased the property for its own account and paid the vendors directly. Adequate documentation of the transactions has been furnished to the Commission to

substantiate the direct purchase.

Simply put, the authorities relied upon by the Commission do not contemplate a situation where the tax exempt entity directly purchased materials for use in construction of real property improvements owned by the tax exempt entity.

POINT II

JUDGE MEMORIAL, A TAX EXEMPT ENTITY, DIRECTLY PURCHASED THE DISPUTED MATERIALS AND, THEREFORE, THE COMMISSION ERRED IN DETERMINING PETITIONER IS LIABLE FOR PAYMENT OF SALES TAXES

It is not disputed that Judge Memorial is a tax-exempt entity. The Final Decision of the Commission finds that petitioner is liable for sales taxes on certain items of personal property purchased directly by Judge Memorial, which were used by petitioner and its subcontractors to complete an addition to Judge Memorial Catholic High School. In making this determination, the Commission made an analysis that totally ignores the tax exemption granted to Judge Memorial by both Article XIII, Section 2 of the Utah State Constitution and U.C.A. § 59-21-104(8).

The Utah State Constitution provides, in part, at Article XIII, Section 2:

(1) All tangible property in the state, not exempt under the laws of the United States, or under this Constitution, shall be taxed at a uniform and equal rate in proportion to its value, to be ascertained as provided by law.

(2) The following are property tax exemptions:

* * *

(c) Property owned by a nonprofit entity which is used exclusively for religious, charitable or educational purposes

Section 59-12-104, provides an exemption from sales and use taxes for sales to or by religious or charitable institutions in the conduct of their regular religious or charitable functions and activities.

While petitioner does not argue that it is responsible for the collection and payment of sales and use taxes on personal property which petitioner purchases and uses in connection with construction of improvements on real property in the ordinary course of its business, petitioner does contend that the Commission far exceeded its authority in imposing on petitioner liability for sales and use taxes in connection with personal property that was purchased directly by Judge Memorial in this case.

The analysis of this case should begin with the genesis of Rule 865-19-58S. Apparently, this administrative rule was promulgated by the Commission to delineate the scope of U.C.A. § 59-12-103, which provides in part:

(1) There is levied a tax on the purchase for the amount paid or charged for the following:

(a) Retail sales of tangible personal property made within the state.

(1) . . . tangible personal property stored, used or consumed in this state.

Rule 865-19-58S was promulgated to establish some guidelines for imposition of the sales and use tax and provides:

A. Sale of tangible personal property to real property contractors and repairmen of real property is generally subject to tax.

1. The person who converts the personal property into real property is the consumer of the personal property since he is the last one to own it as personal property.

2. The contractor or repairman is the consumer of tangible personal property used to improve, alter or repair real property; regardless of the type of contract entered into -- whether it is a lump sum, time and material, or a cost-plus contract.

3. The sale of real property is not subject to the tax nor is the labor performed on real property. For example, the sale of a completed home or building is not subject to the tax, but sales of materials and supplies to contractors and subcontractors are taxable as sales to final consumers. This is true whether the contract is performed for an individual, a religious institution, or a governmental instrumentality.

4. Sales of materials to religious or charitable institutions and government agencies are exempt only if sold as tangible personal property and the seller does not install the material as an improvement to realty or use it to repair

real property.

The rule relied upon by the Commission clearly provides that sales of materials to religious or charitable organizations are exempt if the property sold is tangible personal property and the seller does not install the material as an improvement to realty or use the property to repair real property. The record establishes not only that Judge Memorial directly purchased the property, but that petitioner was not the seller of the property.¹ Thus, the transaction is not taxable, even under the rule promulgated by the Commission.

The Commission's decision is based upon its determination that, in order to benefit from its tax exempt status when making improvements to real property, a religious, charitable, or educational entity must act as its own general contractor. The Commission's decision does not cite any legislative mandate for this determination. The practical effect of the Commission's decision is to abrogate the tax exemption conferred on Judge Memorial by the state constitution and § 59-12-104(8). As this

¹ See, R. 120, Purchase Order from Judge Memorial to Hussey Seating Company; R. 121, Check 1160, in the amount of \$66,827.00, from Judge Memorial payable to Hussey Seating Company; R. 122, Purchase Order from Judge Memorial to Consolidated Electrical Distributors, Inc.; R. 123, Purchase Order from Judge Memorial to Steel Encounters; R. 124, Purchase Order from Judge Memorial to W. R. White Co.; R. 125, Purchase Order from Judge Memorial to Mountain States Insulation & Supply Co.; R. 126, Purchase Order from Judge Memorial to Trane Company; R. 127, Purchase Order from Judge Memorial to C.F.&i Fabricators; R. 128, Purchase Order from Judge Memorial to Rio Grande Building Products; R. 129, Purchase Order from Judge Memorial to Electrical Distributors, Inc.; and R. 130, Purchase Order from Judge Memorial to United Electric Supply Company.

court observed in Utah Concrete Products Corp. v. State Tax Commission, supra:

. . . [T]he interpretation placed on the language of the statute by the Tax Commission must not do violence to its apparent meaning. The construction placed here by the defendant Tax Commission on the Act misinterprets the meaning and intent of the Legislature. it cannot be termed a "practical" construction. Governmental agencies cannot deprive the courts of their judicial functions nor can the agencies extend the operation of the statute by administrative regulations. [Citations omitted.]

125 P.2d, at 412.

A similar observation was made by this court in the Olson Construction Company case, supra. At the time the contracts in that case were in effect, the Commission had enacted Sales Tax Regulation No. 58, which created a sales tax exemption. Discussing that administrative regulation, this court noted:

Nor does the quoted provision of Sales Tax Regulation No. 58 aid the plaintiffs. The Commission has since deleted this provision from its regulations and now contends, with some embarrassment, that it had no legal basis and was contrary to law. We agree with this contention. The regulation went beyond permissible limits of administrative interpretation since it would, on the facts of this case, nullify the applicable statutory definitions of the terms "retail sale" and "retailer" and would grant an exemption where the statutes grant none. This court, while recognizing the possibility that one might be penalized by reliance upon an invalid administrative regulation, has held that an administrative interpretation out of harmony and

contrary to the express provisions of a statute cannot be given weight and, to do so, would in effect amend that statute.

361 P.2d, at 1113, [citing Utah Hotel Co. v. Industrial Commission, 107 Utah 24, 151 P.2d 467, 153 A.L.R. 1176.

The Utah Constitution and § 59-12-104 confer a specific exemption from taxes on sales made to or by religious or charitable institutions in the conduct of their regular activities. That specific exemption is now limited by R-865-19-58S, promulgated to establish guidelines for implementation of § 59-12-103. The Commission is without authority to curtail the exemption granted to Judge Memorial by the state constitution and statute.

POINT III

THE AGREEMENT BETWEEN PETITIONER AND JUDGE MEMORIAL IMPOSES SUFFICIENT RISK AND RESPONSIBILITY ON THE TAX EXEMPT ENTITY

Even if the court were to uphold the validity of R-865-19-58S and the Commission's determination that a tax exempt entity must act as its own prime contractor in order to directly purchase materials which will be used in the construction of real property improvements, the record contains substantial evidence to support a finding that Judge Memorial assumed virtually all risk and responsibility in connection with construction of the improvements.

The Commission's decision sets forth four factors to be considered in determining whether the exempt organization is acting

as the prime contractor. R. 16. To be deemed as the prime contractor, the tax exempt organization must:

- a. Exercise direct supervision over the construction project;
- b. Issue purchase orders to the vendors for all materials and supplies for which sales tax is not paid;
- c. Make direct payment to the vendors for all materials and supplies for which sales tax is not paid; and
- d. Have provisions in any furnish and install contracts to permit changes through change orders to make that portion of the contract a labor only or install only contract, and those contractual provisions must be fully implemented and followed during the construction process.

There is no dispute that Judge Memorial issued purchase orders to vendors for all materials and supplies for which sales tax was not paid. There is no dispute that Judge Memorial made direct payment to the vendors. The Commission determined that Judge Memorial was not acting as the prime contractor on the basis of lack of change orders and lack of direct supervision. The record, however, establishes that Judge Memorial meets both of these elements.

A. Direct Supervision Over the Construction Project.

This case was submitted to the Commission on stipulated facts.

Among those facts is that James Maher, a member of the Board of Financial Trustees of Judge Memorial, oversaw construction of the project, made calculations and offered suggestions regarding construction. R. 8. The Commission concluded that Mr. Maher's primary involvement was to observe the construction progress and report back to the Board. R. 17. There is simply no evidence in the record to support that conclusion. In addition, the Commission simply disregarded the involvement of (1) E. W. Allen and James S. Bailey and their work as independent structural engineers; (2) Dee J. Wamsley and his work as a consulting engineer; and (3) Joe Rhoads and Paul Horton and their work relative to inspection of masonry work.

B. Change Orders.

The Commission also concluded that petitioner assumed the risks, burdens, responsibilities and incidents of ownership during the construction process. R. 24. The stipulated facts, however, establish that Judge Memorial directly purchased the materials, taking title in its own name (R. 8-9); that Judge Memorial insured those materials after delivery (R. 10); that the warranties associated with those materials ran to Judge Memorial and not to petitioner (R. 9); and that Judge Memorial and its agents, as well as petitioner, were responsible for receiving, inspecting, approving and storing the materials (R. 38, Answer to Interrogatory

No. 7).

Much is made by the Commission of the absence of written "change orders" to delete from the contract any responsibility of petitioner for providing materials which were ultimately purchased directly by Judge Memorial. It is the position of petitioner that "change orders" were not required because the contractual agreement between the parties contemplated Judge Memorial would, in fact, directly purchase materials and that a reduction in the total contract price would then be made. Addendum No. One to the contract specifically recognizes that the Owner [Judge Memorial] may decide to utilize its tax-exempt status to purchase materials and equipment to be utilized in the construction project. R. 157. The provision contained in the addendum modified the petitioner's obligation to furnish all labor and materials for the project. R. 184. The contract contains specific provision allowing the property owner to accept materials not in conformity with the requirements of the contract. R. 198.² In addition, the contract reserves to the owner (Judge Memorial), the right to perform the

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If the Owner [Judge Memorial] prefers to accept Work which is not in accordance with the requirements of the Contract Documents, the Owner may do so instead of requiring its removal and correction, in which case, the Contract Sum will be reduced as appropriate and equitable. Such adjustment shall be effected whether or not final payment has been made.

construction and award separate contracts. R. 190.³

It is clear that the Commission's conclusions are not supported by substantial evidence in the record and, for that reason, the Commission's decision must be reversed.

CONCLUSION

By misinterpretation and misapplication, the Commission has converted a sales-use tax into a labor-related taxable incident as a transaction tax, arbitrarily applied to a limited class of contractors. If the purpose of administrative rule is to reach purchases of exempt entities, it is void as in contravention of the state constitution and applicable Utah statutes. In essence, the Commission seeks to impose a use tax on petitioner on the basis that petitioner utilized materials purchased directly by a tax exempt entity to construct improvements on real property also owned by a tax exempt entity. The result of the Commission's decision is that petitioner becomes the agent of Judge Memorial, the property owner, to create a taxable incident, but not to maintain the tax-exempt status.

The more appropriate rule for the Commission to adopt would be

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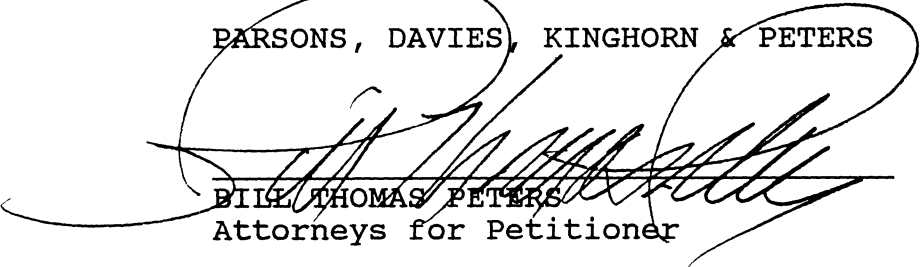
The Owner [Judge Memorial] reserves the right to perform construction or operations related to the Project with the Owner's own forces and to award separate contracts in connection with other portions of the Project or other construction or operations on the site under Conditions of the Contract identical or substantially similar to these including those portions related to insurance and waiver of subrogation. If the Contractor [petitioner] claims that delay or additional cost is involved because of such action by the Owner, the Contractor shall make such Claim as provided elsewhere in the Contract Documents.

that if a contractor or subcontractor acquires the materials for installation and consequent resale to the owner, a taxable event occurs. If the tax-exempt owner acquires materials from whatever separate source, the transactions should be tax free. This rule complies with both the state constitution and § 59-12-104 of the Utah Code. Judge Memorial is undisputedly a tax exempt organization and properly arranged its dealings with petitioner to take advantage of that exemption. The Commission decision negates that exemption through nothing more than linguistic sophistry.

For the reasons set forth above, the decision of the Commission should be reversed and this case remanded with instructions to the Commission to rescind the sales tax assessment against petitioner.

DATED this 12th day of August, 1992.

PARSONS, DAVIES, KINGHORN & PETERS



BILL THOMAS PETERS
Attorneys for Petitioner

CERTIFICATE OF SERVICE

The undersigned hereby certifies that four true and correct copies of the foregoing Brief of Salt Lake County were mailed, postage prepaid, this 12th day of August, 1992, to the following:

R. Paul Van Dam, Esq.
Utah State Attorney General
Clark Snelson, Esq.
Assistant Attorney General
Tax & Business Regulation Division
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Salt Lake City, Utah 84111



BILL THOMAS PETERS

BEFORE THE UTAH STATE TAX COMMISSION

THORUP BROTHERS CONSTRUCTION,)	
INC.,	:	
Petitioner,)	FINDINGS OF FACT,
	:	CONCLUSIONS OF LAW,
v.)	AND FINAL DECISION
	:	
AUDITING DIVISION OF THE)	Appeal No. 89-2518
UTAH STATE TAX COMMISSION,	:	
)	
	:	
Respondent.)	

STATEMENT OF CASE

This matter came before the Utah State Tax Commission for a formal hearing on June 4, 1991. G. Blaine Davis, Commissioner, Presiding Officer, Roger O. Tew, Commissioner, and Paul F. Iwasaki, Administrative Law Judge heard the matter for and on behalf of the Commission. Present and representing the Petitioner was Edward J. McDonough. Present and representing the Respondent were Clark L. Snelson and Brian L. Tarbet, Assistant Utah Attorneys General.

Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax in question is sales and use tax.
2. The period in question is July 1, 1986 to June 30, 1989.

3. The Catholic Diocese of Salt Lake City is organized as the Roman Catholic Bishop of Salt Lake City, a corporation sole (hereinafter "the Diocese"). The Diocese owns and operates Judge Memorial Catholic High School (hereinafter "Judge Memorial"). Judge Memorial is not separately incorporated, but does have a Board of Financial Trustees which oversees the funding and non-academic operation of Judge Memorial.

4. On July 8, 1987, the Diocese entered into a contract with Thorup Brothers Construction Company, Inc., the Petitioner herein, for the construction of an addition to Judge Memorial which included an auditorium, music room and locker rooms.

5. An engineer who was a member of the Board of Financial Trustees, James Maher, volunteered to oversee the project, at times making his own engineering calculations and offering engineering suggestions regarding construction.

6. As a part of the contractual arrangement, Judge Memorial reserved the right to donate materials to be used in the construction of the facility.

7. Judge Memorial exercised its contract option on the project to furnish materials.

8. Judge Memorial secured lists and specifications, from the contractor and then Judge Memorial issued its own purchase orders to the vendors for the materials.

9. Purchase orders totaling \$374,102 were issued by Judge Memorial.

10. With regard to materials purchased, the vendor delivered the materials to the construction site, where they were received, inspected, and stored by the contractor or subcontractor prior to use. The vendor then sent invoices to the particular contractor or subcontractor for approval. Upon approval by the contractor, the invoices were sent to Judge Memorial where a check was issued directly from Judge Memorial to the supplier.

11. Judge Memorial issued checks totaling \$422,226 for materials purchased in the manner described above. The contractor credited Judge Memorial with payment of \$447,580, which represents the amount actually paid for materials, plus sales and use tax which Thorup Brothers had bid into the ~~contract.~~

12. Change Orders were not issued reflecting these credits for material purchased.

13. Warranties on the purchased materials ran to Judge Memorial.

14. Judge Memorial together with the contractor and subcontractors inspected the materials when they arrived on the job site.

15. Judge Memorial hired E. W. Allen and James S. Bailey, independent structural engineers, to work directly for Judge Memorial to perform structural engineering for the project. Scott, Louie & Browning, Architects, retained the services of The Rhoads Company, Inc., Joe Rhoads and Paul Horton, masonry inspectors, to conduct an ongoing inspection of the masonry work on the project.

16. Prime contracts existed between Judge Memorial and Scott, Louie & Browning Architects, and Thorup Brothers Construction Company. Subcontracts were entered into by both prime contractors.

17. Judge Memorial obtained insurance to protect against the risk of loss of the materials through Pacific Employers Insurance Company, which named as insured Judge Memorial and which contained an endorsement which provided: "We will also cover materials, equipment, supplies and temporary structures on your "premises" or in the open (including property inside vehicles) within 100 feet (30.5 meters) of your "premises" used for making additions, alterations or repairs to your "real property" at "covered locations"."

18. Surplus materials were retained by Judge Memorial, and have been stored at Judge Memorial for use in repairs and replacements on the building.

19. The Petitioner purchased and presumably paid sales tax on materials used in the construction of the Judge Memorial addition with the exception of those materials purchased directly by Judge Memorial.

CONCLUSIONS OF LAW

1. Sales made to the state, its institutions, and its political subdivisions are exempt from sales and use taxes. (Utah Code Ann. §59-12-104(2).)

2. Sales made to or by religious or charitable institutions in the conduct of their regular religious or

charitable functions and activities are exempt from sales and use taxes. (Utah Code Ann. §59-12-104(8).)

3. Sales of tangible personal property to real property contractors and repairmen of real property are subject to sales and use taxes. (Rule R865-19-58S).

4. The person who converts personal property into real property is the consumer of the personal property since he or she is the last person to own it as personal property. (Rule R865-19-58S). Utah Concrete Products Corp. v. State Tax Commission, 802 P.2d 408 (Utah 1942); Olson Construction Company v. State Tax Commission, 12 Utah 2d 42, 361 P.2d 1112 (Utah 1961); and Tummurru Trades, Inc. v. Utah State Tax Commission, 802 P.2d 715 (Utah 1990).

~~5. The contractor or repairman is the consumer of~~
tangible personal property used to improve, alter or repair real property. (Rule R865-19-58S).

6. Sales of materials and supplies to contractors and subcontractors are taxable transactions as sales to final consumers, even if the contract is performed for a religious institution, charitable organization, or governmental instrumentality. (Rule R865-19-58S).

7. Sales of materials to religious institutions, charitable organizations, and governmental instrumentalities are exempt only if sold as tangible personal property and the direct or indirect seller does not install the material as an improvement to realty or use it to repair real property. (Rule R865-19-58S).

8. The contractor must accrue and report tax on all merchandise bought tax-free and used in performing contracts to improve or repair real property. (Rule R865-19-58S).

9. Rule R865-19-58S is the primary rule governing the sale of materials and supplies sold to owners, contractors and repairmen of real property, and it sets forth the requirements for the taxation of the sale or acquisition of tangible personal property which is to be used to improve, alter or repair real property. That rule provides in relevant part:

A. Sale of tangible personal property to real property contractors and repairmen of real property is generally subject to tax.

1. The person who converts the personal property into real property is the consumer of the personal property since he is the last one to own it as personal property.

2. The contractor or repairman is the consumer of tangible personal property used to improve, alter or repair real property; regardless of the type of contract entered into--whether it is a lump sum, time and material, or a cost-plus contract.

3. The sale of real property is not subject to the tax nor is the labor performed on real property. For example, the sale of a completed home or building is not subject to the tax, but sales of materials and supplies to contractors and subcontractors are taxable transactions as sales to final consumers. This is true whether the contract is performed for an individual, a religious institution, or a governmental instrumentality.

4. Sales of materials to religious or charitable institutions and government agencies are exempt only if sold as

tangible personal property and the seller does not install the material as an improvement to realty or use it to repair real property.

10. Sales of materials from a vendor to a contractor or other person or entity for use in the construction, improvement, alteration or repair of real property for a governmental entity, religious institution or charitable organization is not exempt from sales and use tax. The incidents of the tax have been imposed on the contractor and not on the exempt entity. To be exempt, the sale must be from the vendor directly to the governmental entity, religious institution or charitable organization for the use of, and consumption by, the exempt entity.

11. The fact that the burden of the tax may be passed ~~by the contractor on to the exempt entity in the form of higher~~ prices and is thus paid indirectly by the exempt entity does not result in tax exemption for the transaction. (Rule R865-19-58S), Utah Concrete Products Corp. v. State Tax Commission, 101 Utah 513, 125 P.2d 408 (1942), and Ford J. Twaits Co. v. Utah State Tax Commission, 106 Utah 343, 148 P.2d 343 (1944), Olsen Construction Company v. State Tax Commission, 12 U.2d 42, 361 P.2d 1112 (1961).

12. Parties seeking exemptions from the imposition of that tax bear the burden of proving that they qualify and are legally entitled to the exemption. Parson Asphalt Products v. Utah State Tax Commission, 617 P.2d 397 (1980).

13. In order for the sale to the exempt entity to be exempt from sales and use tax it must be a bona fide sale to

the exempt entity acting either in the capacity as the final consumer of tangible personal property or the entity which converts the tangible personal property to real property. The sale is such a bona fide sale to an exempt entity only if either:

- a. The sale of materials or supplies is to the exempt entity and the exempt entity has its own employees attach the materials and/or supplies to the realty, or
- b. The sale of materials and supplies is to the exempt entity, and the exempt entity separately hires a contractor to attach the materials and/or supplies to the realty on a labor only or install ~~only contract, or~~
- c. The sale of materials and supplies is to an exempt entity which acts as the prime contractor by converting the tangible personal property to real property.

14. The sale of tangible personal property is not exempt from sales and use tax if the exempt entity is simply acting as the purchasing agent for the general contractor. It is not merely whether the exempt entity engages in the mechanics of a purchase, but rather the legal status of the exempt entity at the time the purchase is made, i.e., is it purchasing the property as the final consumer of the tangible personal property. If the exempt entity makes the purchase for itself and its own use, consumption, or conversion to real

property, the purchase is exempt from sales and use tax. On the other hand, if the exempt entity makes the purchase for another person or entity, or for use, consumption, or conversion to real property by another person or entity, the purchase is not exempt from sales and use tax because the exempt entity has only acted in the capacity of a purchasing agent for the final consumer which is the contractor.

15. If the exempt entity enters into a furnish and install contract with a general or subcontractor which requires the general or subcontractor to furnish and install the materials and supplies, then the exempt entity is not acting as the prime contractor as to the materials and supplies required by contract to be provided by the general or subcontractor.

16. When the general or subcontractor is required by contract to provide materials and supplies and install them on real property, then the contractor is the consumer of that tangible personal property and is liable for the sales and use tax, even if an exempt entity goes through the mechanics of a purchase by issuing a purchase order and a check for payment. The contract is the controlling document, and determines who is the final consumer of tangible personal property, and thus the contract determines upon which party the incidence of taxation falls. Actions taken in noncompliance with the contract may be accepted without objection by the contractor and the exempt entity, but unless the contract is modified or changed by change order to show the consent of the contractor and the

exempt entity to the modifications, the actions that are not in compliance with the contract do not shift or change the incidents of taxation. The written terms of the agreement will govern the taxability of the transaction and not the actions of the parties. This is especially so because written documents can be audited by State Tax Commission auditors, but actions, based on only after the fact statements, allegations or representations are impossible to audit.

17. For the exempt organization to be acting as the prime contractor, the exempt organization, by and through its own employees or agents must:

- a. Exercise direct supervision over the construction project.
- b. Issue purchase orders to the vendors for all materials and supplies for which sales tax is not paid.
- c. Make direct payment to the vendors for all materials and supplies for which sales tax is not paid.
- d. Have provisions in any furnish and install contracts to permit changes through change orders to make that portion of the contract a labor only or install only contract, and those contractual provisions must be fully implemented and followed during the construction process.

18. For the exempt organizations to act as the prime contractor exercising direct supervision over the construction

project it is not necessary to act as the general contractor over the entire project. Instead, the exempt organization must exercise sufficient direct supervision over the purchased materials that there is a change in the legal status of which entity is responsible for those materials. Therefore, the exempt organization may be the prime contractor by exercising sufficient direct supervision over the purchased materials to be the prime contractor for a portion of the total contract. The prime contractor or direct supervision requirement may apply to relationships within the full general contract.

19. To be the prime contractor and exercise sufficient direct supervision, the exempt organization must assume the "burdens of risk" or the "incidents of risk." This requires evidence that the exempt organization has done more than just act as a "purchasing agent" for the general contractor. If a general contractor issues a purchase order on forms of the exempt entity and then later issues authorization for payment by check to the exempt entity, there has just been the creation of a "paper trail" and the direct supervision test has not been met.

20. If the exempt organization and a general contractor enter into a furnish and install contract, the general contractor is contractually required to provide and install those materials. When the contractor provides and installs those materials the contractor is the final consumer of those materials and is required to pay sales or use tax on those materials (Rule R865-19-58S). For the exempt organization to purchase those materials and avoid sales or use

tax, the furnish and install contract must contain a provision permitting change orders so the exempt organization may make such purchases, and the parties must then actually execute such change orders in advance of the purchases. The exempt organization, by its own employees or agents, must then issue purchase orders and vouchers or checks for payment, and must exercise direct supervision over the purchased materials. As evidence regarding whether or not the exempt organization exercised direct supervision over the purchased materials, all of the relevant factors should be reviewed, including:

- a. Who assumed the burdens or incidents of risk?
- b. Who carried the risk of loss in the event of damage or destruction of the materials?
- c. Who, if anyone, carried and paid for
insurance on the materials after delivery
and prior to installation or attachment to
the real property?
- d. Who physically inspected and counted the
materials upon receipt?
- e. If there was a shortage in materials upon
receipt, who was required to pay for
additional materials?
- f. If there was an overage in materials upon
receipt, who retained the surplus materials?
- g. If the materials did not meet specifications
or quality standards, who had the right and
authority to reject those materials?

- h. If materials were rejected for failure to meet quality standards or specifications, and it had resulted in a shutdown of the job, who would have been responsible for the shutdown expenses?
- i. Who was responsible for enforcing any warranties on the materials?
- j. To whom did recourse go if the materials were faulty or defective?
- k. If materials failed after installation, who was responsible for any resulting damages including personal injuries?
- l. To whom did the title pass for the purchased materials?
- m. Were the bills submitted by the vendor directly to the exempt organization?
- n. Did the vendors look only to the exempt organization for payment of the bill?
- o. Did the general contractor or the subcontractor have to approve the bills before they were paid by the exempt organization?
- p. To whom were the materials delivered, i.e., to the contractor, the exempt organization or one of its employees or agents, or directly to the job site?

21. Under a furnish and install contract, the contractor is required to furnish the materials and install

those materials onto real property. Thus, the contractor is required to convert that tangible personal property into real property and the tax is imposed on that consumption of the tangible personal property by the contractor. Therefore, to avoid sales and use tax on materials used for a furnish and install contract, the contract must be modified through the execution and implementation of change orders. When those change orders have been executed and implemented, the modified contract must make it clear that the materials in question have been separately purchased and provided by the exempt organization and that the contractor's only duty with respect to those materials is to provide the labor to install those materials.

22. For the purchases of materials and supplies to be exempt from sales and use tax, the exempt entity must make the purchase and, title to the purchased items must pass to the exempt entity prior to the time it is attached to real property. The exempt entity must deal with the purchased items as its own property and treat those items the same as it would treat items it purchases for its own use and consumption.

DECISION AND ORDER

Sales and Use Tax is imposed not only upon the sale of tangible personal property, but also upon "tangible personal property stored, used or consumed in this state." (U.C.A. 59-12-103[1]). In the construction business, when a person uses lumber, bricks, cement, steel, nails, and other materials to construct a building or other improvements to real estate,

that person has used those materials and has converted the materials into real property. That conversion of tangible personal property into real property is deemed to be the consumption or use of the tangible personal property, which is the taxable event.

The Utah Supreme Court has consistently held that sales and use tax is imposed upon the party that converts tangible personal property into real property. Utah Concrete Products Corp. v. State Tax Commission, supra, Olson Construction Co. v. State Tax Commission, supra, and Tummurru Trades, Inc. v. Utah State Tax Commission, supra. The party that makes that conversion from tangible personal property to real property has used or consumed that property, is the real property contractor, and is taxed on that property. If that conversion to real property is performed by anyone except an exempt entity, the use and consumption of the converted materials is subject to sales and use tax. If the conversion to real property is performed by an exempt entity acting as the real property contractor, the use and consumption of the converted materials is not subject to sales and use tax.

Therefore, the primary issue in this case is to determine whether the Petitioner or Judge Memorial was the real property contractor. If a preponderance of the evidence indicates that Petitioner was the party that converted the tangible personal property into real property, then Petitioner was the real property contractor and is liable for the tax assessed by the Auditing Division. However, if a preponderance of the evidence indicates that Judge Memorial was the party

that converted the tangible personal property into real property then Judge Memorial was the real property contractor and was exempt from the sales and use tax.

To determine which party was the real property contractor, it is necessary to review and analyze the full scope of the contract and the legal rights, duties, obligations, and relationships of the parties with respect to the materials converted into real property. The primary evidence available to the Commission to make that determination is the contract and agreement, together with all duly executed change orders and other written documents. Oral testimony is beneficial in interpreting the documents and gaining some insight into the conduct of the parties and, to some extent, their understanding of the requirements of the contract. However, where any inconsistencies may exist between the written contract, including executed change orders, and either the conduct or oral testimony of any person, the written contract must be presumed to govern or prevail.

In this proceeding, a preponderance of the evidence shows that the legal rights, duties and obligations of Judge Memorial did not rise to the level of the real property contractor because Judge Memorial did not assume the burdens, risks, responsibilities and incidents of ownership of the materials being converted to real property. Except for the paper work involved in the purchase order and the check for payment, Judge Memorial had only minimal involvement in the project, during the construction process. Petitioner had

nearly total control of and responsibility for the materials during the construction process. The Petitioner provided lists, specifications and costs of materials to be purchased, and then received, inspected, approved and stored the materials, signed the invoices, and was fully responsible for the materials and any problems with the materials. The Petitioner had to approve the invoices before they would be paid by Judge Memorial. Change orders were never executed to remove from the Petitioner the contractual obligation to provide materials and to remove the value of those materials, plus sales tax, from the amounts to be paid to Petitioner from Judge Memorial. The Petitioner, and not Judge Memorial, assumed nearly all of the burdens, risks and incidents of ownership of those materials.

Judge Memorial did have a volunteer engineer who was a member of their Board of Trustees who assisted Judge Memorial and reviewed the project, but there is no evidence that he had any authority to be involved in the management of that project. It appears that his role was primarily to observe the construction progress and report back to the Board. There is no evidence that he had any responsibility to review or even look at the materials which the Petitioner alleges had been purchased by Judge Memorial, and there is no evidence that he was in any way involved with the materials that were converted to real property.

Judge Memorial did carry insurance on those materials, but the Petitioner had most of the other burdens, risks, responsibilities, and incidents of ownership on those

materials. The Petitioner was contractually required to provide the materials for its portion of the project. Petitioner installed those materials onto the project, and acted as the owner of those materials by assuming the risks, burdens, responsibilities and incidents of ownership during the construction process. A preponderance of the evidence indicates that Petitioner converted those materials from tangible personal property into real property. Therefore, Petitioner was the real property contractor for those materials and pursuant to Rule R865-19-58S was liable for the use tax on those materials.

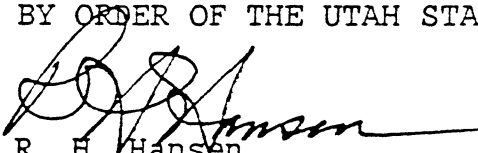
Petitioner relies upon Horne Construction v. the Auditing Division of the Utah State Tax Commission, decided by the Tax Commission in November of 1987, and takes the position that this case is almost identical to Horne Construction. However, in addition to the different ways of handling change orders, and the differences in receipt, inspection and storage of the materials, there is a substantial difference in the supervision of the projects. In Horne, the school district hired a licensed contractor with more than 30 years of construction experience, and gave him substantial authority. Pursuant to the contract, he would receive and inspect the goods and would inspect all facets of the construction. He had the authority under the contract to stop work on the project or reject materials. In essence, he was in control of the project, which made the school district the prime contractor. In this proceeding, Judge Memorial had one of its trustees voluntarily assist and review the construction. However, he

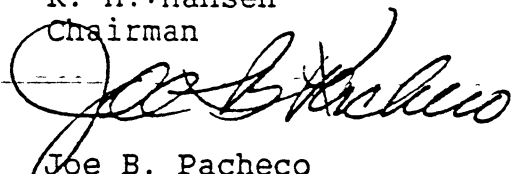
had no contractual responsibility or authority to inspect the materials, stop the construction, or make any changes or alterations. His services were of value and benefit to Judge Memorial, but with no contractual rights his services have very little legal significance in this proceeding.


Based upon the foregoing, it is the order of the Utah State Tax Commission that the Petition for Redetermination is hereby denied, and the audit assessment made by the Auditing Division is affirmed. It is so ordered.

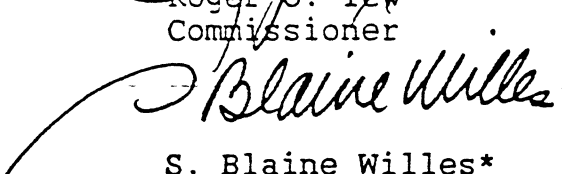
DATED this 10th day of March, 1991⁹².

BY ORDER OF THE UTAH STATE TAX COMMISSION.


R. H. Hansen
Chairman


Joe B. Pacheco
Commissioner


Roger O. Tew
Commissioner


S. Blaine Willes*
Commissioner

NOTICE: You have twenty (20) days after the date of the final order to file a request for reconsideration or thirty (30) days after the date of final order to file in Supreme Court a petition for judicial review. Utah Code Ann. §§63-46b-13(1), 63-46b-14(2)(a).

*Since the hearing on this case, Commissioner G. Blaine Davis has been replaced by S. Blaine Willes. Commissioner Willes has been duly advised of the facts and circumstances regarding this case, and is qualified to sign this decision.

GBD/wj/2689w



Appeal No. 89-2510

Appeal No. 89-2518

MAILING CERTIFICATE

I hereby certify that I mailed a copy of the foregoing
Decision to the following:

Thorup Brothers Construction, Inc.
c/o Edward J. McDonough
50 South Main, Suite 1250
Salt Lake City, Utah 84144

James H. Rogers
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Assistant Attorney General
36 South State Street, 11th Floor
Salt Lake City, Utah 84111

DATED this 10th day of March 1992.

Sara Jensen
Secretary

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FILED

APR 9 1992

CLERK SUPREME COURT
UTAH

IN THE SUPREME COURT OF THE STATE OF UTAH

THORUP BROTHERS CONSTRUCTION, INC.,	:	
	:	PETITION FOR REVIEW OF
	:	FINAL DECISION
Petitioner	:	OF STATE TAX COMMISSION
	:	
-vs-	:	
	:	
AUDITING DIVISION OF THE	:	
UTAH STATE TAX COMMISSION,	:	Docket No.
	:	
Respondent.	:	

Pursuant to Utah Code § 59-1-505 (1987-88) and Rule 14 of the Rules of Civil Procedure, and in compliance with Utah Code §59-5-211 (1987-88) and R861-1-8A of the Utah Administrative Code, (1987-88), Thorup Brothers Construction, Inc., hereby petitions the Utah Supreme Court for review of the Findings of Fact, Conclusions of Law, and Final Decision dated March 10, 1992, of the Respondent Auditing Division of the Utah State Tax Commission ("Commission"). As grounds for this Petition for Review and in compliance with applicable statutes and rules, Thorup Brothers Construction, Inc., alleges as follows:

1. The Findings of Fact, Conclusions of Law, and Final Decision of the Commission dated March 10, 1992, is a final order of the Commission over which the Utah Supreme Court has appellate jurisdiction pursuant to Utah Code § 78-2-2(e)(ii) (1986-87). The

Supreme Court's jurisdiction over this matter is not subject to transfer to the Court of Appeals. Utah Code § 78-2-2(4)(4) (1986-87).¹

2. Section 63-46b-16, provides for judicial review by the Supreme Court or Court of Appeals of "all final action resulting from formal adjudication proceedings." Utah Code § 59-1-505 (1987-88).

3. This appeal comes to the Court upon a Final Decision of the Commission after a Formal Hearing which Final Decision was issued on the 10th day of March, 1992.

4. Utah Code § 59-1-505 (1987-88) requires, as a condition precedent to appeal, that the aggrieved taxpayer deposit with the Commission the full amount of taxes, interest and penalties audited and stated in the Decision of the Commission. The taxes, penalties and interest assessed against Petitioner were paid in full to the Commission on April 7, 1992.²

5. This Petition is timely made as it is filed within thirty (30) days of the final decision of the Commission.

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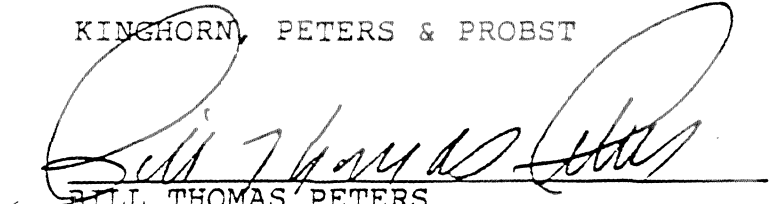
H.B. 394 amending Utah Code § 78-2-2(4) to allow transfer of tax cases to the Court of Appeals is not in effect until April 27, 1992.

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Section 59-5-211 further requires taxpayers to file an undertaking, "in such amount and with such surety as the Commission shall approve to the effect that if such appeal is dismissed or the decision of the Commission affirmed the party appealing will pay all costs and charges which may accrue against him in the prosecution of the case" This undertaking is also referenced in the administrative regulation applicable to appeals taken under § 59-1-505. Utah Admin. R. R861-1-8A (1987-88). Counsel for Thorup has been advised by the Counsel for the Commission that no undertaking is required by the Commission in this case since the full amount of taxes in dispute has been paid to the Commission. Counsel for the Commission has executed a Stipulation waiving the required undertaking.

DATED this 9th day of April, 1992.

KINGHORN, PETERS & PROBST


BILL THOMAS PETERS
Attorneys for Petitioner

CERTIFICATE OF SERVICE

I hereby certify that I mailed, postage prepaid, a true and correct copy of the foregoing PETITION FOR REVIEW OF FINAL DECISION OF STATE TAX COMMISSION, to the following this 9th day of April, 1992:

Utah State Tax Commission
160 East Third South
Salt Lake City, Utah 84111

James H. Rogers, Director
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BILL THOMAS PETERS